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Bell Atlantic

June 8, 1999

Ex Parte

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
The Portals
445 12th Street, SW
Washington, DC 20554

Re: CC Docket No. 98-166

Dear Ms. Salas:

Today, Dr. James Vander Weide, Research Professor of Finance and Economics at the Fuqua School of Business of Duke University, accompanied by Pete Cummings of US West, Bob Deter of GTE, and Eddie Googe and me, representing Bell Atlantic, met with Tony Dale, Tom David, Rick Robinson, Gary Siegel, and George Williams, of the FCC's Common Carrier Bureau regarding the item captioned above. The attached material served as the basis for the presentation and ensuing discussion.

If you have any questions regarding the attached, please contact me at the address shown above.

Sincerely,

Kenneth Rust

Attachment

cc:
A. Dale
T. David
R. Robinson
G. Siegel
G. Williams

No. of Copies rec'd 0+1
List A B C D E

RATE OF RETURN REPRESCRIPTION

BELL ATLANTIC, GTE, US WEST EX PARTE

June 8, 1999

CC Docket No. 98-166

COST OF CAPITAL > 11.25%

- Commission should use market value capital structure.
- RBOCs are a poor proxy.
- Risk has increased significantly.
- S&P Industrials are the best proxy.
- MCI's arguments are wrong.
- Cornell/Hirshleifer analysis should be rejected.
- 12.75% ≤ ILEC cost of capital ≤ 13.15%.

Why Market Value Capital Structure?

- **Investors calculate actual and required rates of return in terms of the market value of their investment.**
- **Since investors are forward looking, market values best represent the amounts of debt and equity investors have invested in the company.**
- **New capital is raised in the marketplace at *market prices*, not book value.**

Why Market Value Capital Structure?

- Companies are acquired and sold at market value, not book value.
  - WorldCom was able to acquire a much larger company, MCI, because of the market value of its equity.
- Financial decision makers base investment and financing decisions on market values.
- Economic and financial theory requires use of market values.

Why Market Value Capital Structure?

- **LEC market value capital structure contains 75% - 80% equity.**
  - **The LECs' market value capital structure has averaged 75% - 83% equity over the last ten years.**

Why Market Value Capital Structure?

- At 30 September 1998, these companies had more than 80% equity in their market value capital structures:
  - The S&P Compustat telecom companies - 83.2%.
  - The RHCs and GTE - 81.8%.
  - AT&T and MCI - 87.2%.
  - The S&P Industrials - 82.2%.

Why Market Value Capital Structure?

- A LEC market value capital structure with 75% - 80% equity is consistent with Wall Street valuations of LEC operations.
  - Wall Street values LEC operations using EBITDA multiples of 7 to 8.
  - To be conservative, we reduced this multiple by 15%.
  - This valuation produces an average capital structure for the operating local exchange companies containing 78% to 84% equity.

Why Not Book Value Capital Structure?

- **Book values are meaningless.**
  - **Book values do not reflect the historical financing of the LECs.**
  - **Book values depend on accounting rules.**
    - **Inherently backward-looking.**
    - **Influenced by one-time write-offs and extraordinary charges , which have no impact on market value (e.g., FAS 71, OPEB, MCI $3.8b charge).**
    - **Allow for managerial discretion.**

Why Not Book Value Capital Structure?

- Investors recognize that book values are meaningless.
  - Winstar has market capitalization of more than $2b, but book value less than zero.
- Use of book values would send incorrect economic signals.
  - Disincentive to potential entrants to build their own facilities at market-determined rates.
  - Disincentive to incumbents to expand and upgrade facilities.

AT&T's Use of an Average of Market and Book Value Capital Structures Should Be Rejected.

- AT&T recognizes that market value capital structures are consistent with economic theory.
- AT&T fails to recognize that the equity in the RHCs' book value capital structures has been reduced by at least 52% as a result of accounting write-offs.
- Reasonable valuation of LEC assets produces market value capital structures containing 80% equity.

Book Value No Longer Approximates Market Value

Company	Market Value 12/31/97	Book Value	Market-to-Book	Market Value 12/31/84	Book Value	Market-to-Book
Ameritech	44,194,500	8,308,000	5.3	7,528,911	7,087,496	1.1
Bell Atlantic	70,666,050	13,900,802	5.1	8,006,736	7,508,496	1.1
BellSouth	55,861,504	15,669,000	3.6	10,170,576	9,414,496	1.1
GTE	50,055,500	10,291,000	4.9	8,297,332	8,509,167	1.0
SBC	67,290,453	9,892,000	6.8	7,042,088	6,994,789	1.0
US West	21,863,739	4,199,000	5.2	6,790,983	6,647,500	1.0
Average	309,931,746	62,259,802	5.0	47,836,626	46,161,944	1.0

RBOCs Are a Poor Proxy

- **The group of RBOCs is too small to provide reliable estimates of the cost of equity.**
  - **The set of RBOCs contains only five firms, four of which are involved in significant mergers.**
- **The RBOCs are involved in dramatic industry restructuring.**
  - **Regulatory restructuring.**
  - **Rapid technological change.**
  - **Convergence of voice, video, and data.**
  - **Mergers and acquisitions.**

RBOCs Are a Poor Proxy

- **Telecommunications represents a high percentage of all merger activity.**
  - **Communications is the number one industry for merger activity in 1999. (Mergerstat.)**
  - **At mid-May, the four biggest mergers (and five of the top six) involved communications companies, with a value of $177.8B. (Mergerstat.)**
  - **Communications was the number two industry for mergers in 1998 (behind only financial services, which would not be included in the S&P Industrials). (Mergerstat.)**

RBOCs Are a Poor Proxy

- **Using RBOCs as proxy causes DCF results to be understated.**
  - **Data mismatch: investors bid stock prices up in anticipation of growth opportunities associated with merger restructuring, but analysts' growth forecasts do not reflect these changes until restructuring is complete.**
  - **Merging telecommunications companies' growth rates increase significantly after merger is completed.**

IBES Growth Rates and RHC Mergers

Merging Companies	Merger Announced	Merger Closed	IBES g 1 Mo. Prior to Announce	IBES g 1 Mo. after Close	IBES g May 99 Forecast
SBC Communications	4/1/96	4/1/97	9.50%	10.31%	11.57%
Pacific Telesis			3.54%		
Simple Avg IBES "g"			6.52%		
Market Value Wtd Avg			7.89%		
Bell Atlantic	4/22/96	8/14/97	7.66%	8.15%	9.41%
NYNEX			6.62%		
Simple Avg IBES "g"			7.14%		
Market Value Wtd Avg			7.20%		
SBC Communications	1/5/98	10/26/98	9.75%	10.68%	11.57%
SNET			6.50%		
Simple Avg IBES "g"			8.13%		
Market Value Wtd Avg			9.61%		
Ave. time from announcement to close	12 Months				
Ave. increase in g	1.48%				

RBOCs Are a Poor Proxy

- **Using RBOCs as proxy causes CAPM results to be understated.**
  - **Beta estimates are based on five years of historical data.**
  - **Historical betas are poor measures of future risk for restructuring companies.**
  - **An increase in risk may reduce the measured beta.**
  - **The RBOCs' measured betas are less than 1.0.**
  - **The CAPM underestimates cost of equity for companies with beta < 1.0.**

Risk Has Increased Significantly Since 1990

- MCI and AT&T have acquired largest CAPS and cable TV companies.
- MCI and AT&T now have direct connections to most US business customers.
- AT&T will have direct connections to more than 60% of US homes.
- Customers avoid access charges through use of ISPs and wireless.

Risk Has Increased Significantly Since 1990

- **In 1998, CLECs added more new business lines than RBOCs.**
- **CLECs will capture 40 - 50% of business access lines by 2007.** ("Telecommunications Services," PaineWebber, July 27, 1998.)
- **A customer survey conducted for Morgan Stanley indicates that "AT&T would take 42 percent share in a competitive market for local and long distance residential customers."** ("Telecommunications Services," Morgan Stanley Dean Witter, August 11, 1997, p. 3.)

S&P Industrials Are the Best Proxy

- **S&P Industrials satisfy assumptions of traditional cost of equity methods.**
  - **Relatively constant business operations.**
  - **Relatively constant financing policies.**
- **S&P Industrials are large sample.**
  - **Some 300 companies in the S&P Industrials have data required to perform reliable DCF analyses.**
  - **Results will not be skewed by firms that do not satisfy assumptions of cost of equity methods.**
  - **RHCs and S&P Industrials have similar risk profiles.**
  - **FCC has accepted S&P Industrials as proxy in the past [See Fn. Order, 5 FCC Rcd 7507 at ¶182 (1990).]**

MCI's Arguments Are Wrong

- More than 90% of the LECs' investment in their networks has been financed by equity holders for the past five years.
- The Vander Weide S&P group is similar in risk to the RBOCs.
  - The Value Line Safety Rank for Vander Weide S&P group is approximately equal to the Value Line Safety Rank for the ILECs (1.68 for Industrials, 1.69 for ILECs, where 1 is highest).
- Cost of equity is 14.52% for S&P Industrials with betas between .70 and .95.

LECs' Investment in their Networks Has Been Financed by Equity Holders

	1998	1997	1996	1995	1994	Average
CFFO	16,596.31	15,611.92	14,870.32	12,625.10	12,553.73	14,451.48
Less Dividends	6,182.38	6,720.78	5,985.37	4,864.38	4,705.16	5,691.62
Less CAPEX	10,867.99	10,177.03	8,923.89	8,374.01	8,241.75	9,316.93
Exterior Financing	-454.06	-1,285.89	-38.93	-613.29	-393.18	-557.07
% Internally Funded	95.8%	87.4%	99.6%	92.7%	95.2%	94.0%

Cornell/Hirshleifer Analysis Should be Rejected

- Cornell/Hirshleifer three-stage DCF Model produces nonsensical results.
- Cornell/Hirshleifer's cost of capital estimates are inversely related to risk.
  - Return = 10.56% - (1.88% X beta)
- Vander Weide cost of capital estimates are correlated with risk.
  - Return = 8.64% + (6.0% X beta)
- Regressions comparing Cornell/Hirshleifer and Vander Weide results for S&P Composite are statistically valid.

12.75%≤ILEC Cost of Capital≤13.15%

- **Assumptions**
  - **Market Interest Rate (6.68%).**
  - **Market Value Capital Structure (75% - 80% Equity).**
  - **S&P Industrial Proxy Group.**
  - **Classic DCF.**
  - **Market Cost of Equity (14.77%).**
- **Market interest rate has increased 75 basis points since Vander Weide estimate (6.68% is the lowest rate in the past 12 months; rate week of May 17, 7.43%).**